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REVIEW OF THE UNFPA POLICY ON INDIRECT COST RECOVERY

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I. INTRODUCTION

1. In decision 2005/12, the Executive Board of UNDP and of UNFPA endorsed, on an interim basis, the UNFPA-specific implementation of the harmonized cost-recovery principles, consisting of a rate of 5 per cent on nationally executed cost-sharing expenditures financed by programme countries, and a rate of 7 per cent on all other co-financed expenditures. In the same decision, the Board encouraged UNFPA to intensify consultations for further harmonization of cost-recovery principles within the United Nations Development Group (UNDG). In addition, the Board requested UNFPA to review the implementation of the new policy on indirect cost recovery, and to prepare a report to the Board, for presentation at the annual session 2007. This report reviews the UNFPA policy on indirect cost recovery and also includes an update on the status of harmonization of cost-recovery policies.

II. HARMONIZATION OF COST-RECOVERY POLICIES

2. In document JIU/REP/2002/3, *Support costs related to extrabudgetary activities in organizations of the United Nations system*, the Joint Inspection Unit (JIU) encouraged the United Nations system to harmonize its approaches to indirect cost recovery. While the JIU refrained from proposing a unified rate across the United Nations system, it recommended a consistent approach to cost recovery. Accordingly, UNFPA has endeavoured to harmonize cost-recovery principles and definitions. The revised policy is simple, clear and transparent, and the applicable rates satisfy the JIU core principle of avoiding cross subsidization of different funding modalities.

3. In 2005, a UNDG working group, consisting of representatives of UNDP, UNFPA, the United Nations Children's Fund, the United Nations World Food Programme, and the United Nations Educational, Scientific and Cultural Organization (as an observer), met to develop options to further harmonize cost-recovery rates for multi-donor trust funds, joint programmes and joint offices. In its report (CEB/2006/HLCM/20), the working group concluded that the UNDG Executive Committee agencies have based their specific cost-recovery policies on harmonized cost principles. Cost recovery is generally applicable to variable indirect costs, to ensure that each source of funding ultimately bears all attributable costs. In the same report, the working group noted that the recovery rates in the UNDG Executive Committee agencies are harmonized and range from 5 per cent to 7 per cent.

4. The common methodology adopted by UNFPA for calculating the cost-recovery rate is based on the classification of support costs into: (a) direct costs; (b) fixed indirect costs; and (c) variable indirect costs. Depending on the ratio of regular (core) resources to "other" (co-financing) resources, the variable indirect costs are incrementally attributed to the administration of "other" resources. In order to further enhance the effectiveness and consistency of cost recovery, the UNDG Executive Committee agencies have adopted harmonized definitions of the costs underlying the recovery policy and the rate-determination models.

Harmonized cost definitions (as contained in document CEB/2006/HLCM/20)		
Direct costs	**Fixed indirect costs**	**Variable indirect costs**
All costs that are incurred for and can be traced in full to an organization's activities, projects and programmes in fulfilment of its mandate. Included are the costs of project personnel, equipment, project premises, travel and any other input necessary to achieve the results and objectives set out in programmes and projects.	All costs that are incurred by the organization regardless of the scope and levels of its activities, and which cannot be traced unequivocally to specific activities, projects or programmes. These costs typically include the top management of an organization, its corporate costs and statutory bodies not related to service provision.	All costs that are incurred by the organization as a function and in support of its activities, projects and programmes, and which cannot be traced unequivocally to specific activities, projects or programmes. These costs typically include services and administrative units, as well as their related system and operating costs.

5. A common understanding of which costs fall under each of the three categories above, and a consistent application of the above definitions, will ensure that cost-recovery rates are fully harmonized among the UNDG Executive Committee agencies.

III. UPDATE ON THE UNFPA COST-RECOVERY POLICY

6. As reported by UNFPA in document DP/FPA/2006/3, the level of co-financing income has increased steadily in recent years while the ratio of co-financing income to overall income remained stable, at about one third of overall resources. The growth in volume and the continued predominance of regular resources is an expression of donor confidence in UNFPA. As reiterated by the Executive Board in decision 2005/12, regular resources must remain the bedrock of contributions to UNFPA.

7. In 2005, UNFPA began to implement the new cost-recovery policy endorsed by the Executive Board in decision 2005/12. Donors, implementing partners and UNFPA staff appreciate the simplicity of the new framework. The applicable rates are different for host countries as well as for third-party procurement. The simplicity of the rate structure and the underlying rationale have shortened the time required to negotiate co-financing agreements. As soon as the UNDG finalizes the harmonized operational guidelines on permissible direct costs, UNFPA expects that these guidelines will further improve the management of co-financing funds.

8. In decision 2005/12, the Executive Board requested the Executive Director to prepare a report that: (a) reviews the indirect cost-recovery policy on the basis of the actual data from the Atlas system; (b) proposes amendments, as necessary, based on whether the goal of no cross subsidization is attained; and (c) indicates whether there are categories of co-financing activities that have significantly higher or lower indirect costs compared to the rates applied.

9. Even though UNFPA introduced the new cost-recovery policy in 2005, it could not be applied retroactively to existing co-financing agreements; therefore, the available data constitutes an amalgamation of the old and new policies. Thus, any conclusion reached about the adequacy of the new rate structure is preliminary and must be validated with more comprehensive data.

10. Using the same indirect cost-recovery model as elaborated in document DP/FPA/2005/5, *Recovery of indirect costs for co-financing*, UNFPA has estimated actual indirect costs to the Fund as percentage of co-financing expenditure. In this model, fixed costs do not increase with the volume of co-financed expenditure. For example, the Office of the Executive Director and the Division for Oversight Services operate irrespectively of the level of co-financing; therefore, all of their biennial support budget expenditures are considered fixed. The remaining UNFPA divisions devote their variable costs (total costs less fixed costs) to managing and administering both regular and co-financing resources. According to the approved methodology, variable costs are apportioned according to the relative share of co-financing to total resources. The variable costs attributed to co-financing resources represent the indirect costs that are eligible for recovery.

11. Based on this model, the amount required to recover indirect costs for 2006 was equal to 7.1 per cent of co-financed expenditures, while for 2005 the equivalent percentage was 6.0 per cent, with an average of 6.6 per cent for both years.

12. When compared to the required cost-recovery rate of 6.6 per cent, the actual cost-recovery rate based on expenditures against contributions from both donor countries and programme countries (excluding third-party procurement), was slightly lower, at 6.3 per cent. The slight difference can be attributed to the lower recovery rate of 5 per cent applicable to cost-sharing projects funded by programme countries

13. The above statistics indicate that actual recovery has been consistent with the required rate over two years; hence the objective of no cross subsidization has been achieved. Therefore, UNFPA does not wish to amend its present rate for its policy on indirect cost recovery.

14. Since indirect variable costs are by nature indirect, they cannot be directly linked to specific co-financing activities. For this reason, they can only be viewed as a single pool of costs – untraceable and non-attributable to any particular activity or programme. Any attempt to attribute any portion of this pool to a specific co-financing programme is arbitrary and inaccurate. Hence, UNFPA believes that it is not possible to determine categories of co-financing activities that have significantly higher or lower indirect costs.

15. Since the new cost-recovery rates have been in force for only two years, and taking into account the overlap with the old cost-recovery policy during this period, UNFPA will carry out a similar analysis in 2009, as part of its continuing review and monitoring of cost-recovery rates, to ensure that they are adequate and that no cross subsidization occurs.

16. The ability of UNFPA to successfully implement programmes and activities is limited and finite during a biennium. If the level of "other" resources increases beyond the established threshold, it will be necessary to have a corresponding increase in capacity to implement projects. While the variable indirect costs should fluctuate with the level of activities, the ability to increase indirect variable costs commensurate with the level of "other" resources is limited by the approved level of the biennial support budget. Hence,

there is a need for indirect cost-recovery amounts exceeding the threshold to be given to programme resources in order to augment capacity for the timely execution of projects. UNFPA will address this issue in the next biennial support budget.

IV. ELEMENTS OF A DECISION

17. The Executive Board may wish to:

(a) Recall decision 2005/12 on the recovery of indirect costs for co-financing;

(b) Take note of the present report (DP/FPA/2007/9) and of the status of implementation of the new cost-recovery policy;

(c) Welcome the progress made within the UNDG on the harmonization of recovery policies and urge the UNDG to reach a common agreement on what constitutes direct costs;

(d) Take note of the transparency and simplicity of the new cost-recovery policy, and reaffirm its endorsement of the new policy;

(e) Encourage UNFPA to continue its active involvement in the UNDG working groups on harmonizing cost-recovery policies;

(f) Encourage UNFPA to present proposals to the Executive Board, as part of the biennial support budget, 2008-2009, on how a portion of indirect cost recovery can be used to build capacity in programme implementation;

(g) Request UNFPA to provide to the Executive Board, at its second regular session 2009, an update on the UNFPA policy on indirect cost recovery.